



6th ECB Banking Supervision Market Contact Group (BSMCG) meeting

Thursday, 15 February 2024, physical meeting

MEETING SUMMARY

Claudia Buch, Chair of the Supervisory Board, opened the sixth meeting of the BSMCG. Ms Buch outlined the agenda and recalled that the exchanges of views with market participants are an essential component of the market intelligence activities conducted by ECB Banking Supervision to support its assessment of the main risks and vulnerabilities of the banking sector.

1. European banking sector outlook

BSMCG members stressed European banks' broad resilience to the recent macro-financial headwinds, driven *inter alia* by their solid capital positions and liquidity buffers and the shift away from exposures towards riskier sectors. So far and with the exception of certain targeted sectors (e.g. commercial real estate), no significant increase has been recognized in the credit risk of banks' portfolios despite the fast-paced tightening of financing conditions. This trend is not expected to substantially change in the short- and medium-term owing to the lower interest rate sensitivity of banks' loan books and the observed broader resilience of the property markets compared to previous tightening cycles. The expiration of the fiscal support in the form of loans and guarantees also did not result in a material increase in non-performing loans. Regarding banks' funding, some members highlighted the growing competition from government bonds issuances and the impact this may have on banks' funding costs (from both retail and wholesale sources). The profitability of European banks is expected to remain strong in the near term in light of the structurally higher rates regime characterising the current operating environment.

The repercussions for banks of the high uncertainties surrounding the inflation path, the economic growth outlook and the broader geopolitical landscape were key themes discussed in the meeting. Some members pointed out that there have been also in the past periods of heightened geopolitical risk and increasing tensions are no exception. In addition, geopolitics are not a direct concern for banks but rather have an indirect impact through second-round effects on the general macroeconomic environment. Other members however argued that coming from a recent period of relatively low policy uncertainty, banks need to prepare for scenarios in which binary outcomes are much more likely and adjust their business models and

operations, as geopolitical risk might not be fully priced in currently in their models. In this regard, the value of diversification might also be changing and not always be as positive in a more fragmented world. Banks need to be able to navigate through episodes of heightened volatility of financial markets, which may be triggered by escalating geopolitical conflicts.

Banks are also confronted with rising challenges from cyber threats, which many members assessed as being part of the most material risks to banks in the current environment. There was broad agreement that a major cyber-attack represents a large tail risk to banks, however it is extremely difficult to predict and analyse the potential impact and spill-over effects through the system. In this regard, the ongoing cyber resilience stress test conducted by ECB Banking Supervision will provide valuable insights. Some members highlighted further that while proximity to a geopolitical conflict might be a factor for more elevated cyber threats, the banking sector has shown quite robust defences in comparison to other sectors. In addition, supply chain vendors are seen as much more vulnerable to cyber threats relative to banks as often they have less developed cyber resilience frameworks and do not conduct regular stress-testing exercises considering also possible contagion effects among different customers. Given the increasing dependency of banks on third party providers, it is thus key that banks properly manage their outsourcing risk. Many members were of the opinion that the risk is further amplified by the shortage of talent in cyber security and the increasing use of Artificial Intelligence by cyber criminals.

2. European banks' valuations – drivers and structural differences to international peers

With respect to banks' equity valuation, BSMCG members stressed the importance of the geographical location and the general macro-financial environment as key drivers of the performance: while banks operating in countries with a stronger nominal growth are *ceteris paribus* valued higher, European banks face multiple headwinds from the weaker growth outlook which limits lending growth opportunities and the development of new business. Different productivity dynamics across countries and the capacity of the economy to enable new technologies to enhance their real revenues and increase overall productivity are additional factors supporting growth prospects. These specificities are, however, not specific to the banking sector as confirmed by ECB Banking Supervision analyses which point towards structural valuation gaps¹ across sectors between the EU and US, with the financial sector being one of the sectors with the lowest relative gaps. During the discussion, some members highlighted that in a more fragmented world economy, the home bias will increase further in importance and will drive to a large extent valuation dynamics.

In addition, members touched upon issues related to the different role banks play in the society as the home location also implies differences in the social contracts, demographical trends, or countries' internal ability

¹ The valuation gap was measured by the average difference in Price-to-Book ratios between listed firms of the respective sector in EU and US.

of risk-sharing. In this regard, members pointed out that banks tend to play a larger social and environmental role in Europe compared to other developed countries. The little progress achieved so far in the development of the European Capital Market Union and the incomplete Banking Union present major impediments for banks' consolidation. While large investments are needed to address the increasing digitalisation and climate challenges, Europe is lagging its peers and the public pushback on climate policies is growing. During the discussion, the point was also raised that while it is difficult to measure a direct link between banks' valuations and their general IT expenses, targeted IT investments such as preserving cyber security and improving clients' experience are crucial for banks to compete against their peers.

Furthermore, BSMCG members highlighted the importance of a transparent and predictable approach by the responsible authorities when it comes to dividend distributions, share buy-backs and taxes on profits as markets consider these issues as crucial for European banks' valuations. Some of the members pointed out that banking in Europe seems to have become less cyclical and more stable in recent years, thanks also to the standards setters and supervisors, and is increasingly perceived as utilities, characterised by rather stable level of capital distributions. Despite recent high earnings, the sector is still trading at a low level compared to its history.

3. Concluding remarks

Ms Buch concluded the meeting by thanking the members for their contributions and active participation in the discussions. The next meeting is expected to take place in the second half of 2024.